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In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-22

IVAN ALLEN COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF ON BEHALF OF PETITIONER

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OPINIONS BELOW

The opinions delivered in the courts below are: (1) the opinion of the United States Court of Appeals for the Fifth Circuit reported at 493 F.2d 426 (5th Cir. 1974); and (2) the opinion of the United States District Court for the Northern District of Georgia reported at 349 F. Supp. 1075 (N.D. Ga. 1973).

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on May 3, 1974. The petition for a writ of certiorari was docketed in this Court on July

26, 1974 and was granted on December 16, 1974. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

INTERNAL REVENUE CODE of 1954, as amended, United States Code, Title 26:

"Sec. 531. *IMPOSITION OF ACCUMULATED EARNINGS TAX.*

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27 1/2 percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38 1/2 percent of the accumulated taxable income in excess of $100,000.

"Sec. 532. *CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.*

(a) GENERAL RULE—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * *

"Sec. 533. *EVIDENCE OF PURPOSE TO AVOID INCOME TAX.*

(a) UNREASONABLE ACCUMULATION DETERMINATIVE OF PURPOSE—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

TREASURY REGULATIONS, 26 C.F.R. 1.535-3(b)(1)(ii):

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 37 and §§ 1.537-1 and 1.537-2."

QUESTION PRESENTED FOR REVIEW

Whether, in determining the applicability of Section 533(a) of the Internal Revenue Code of 1954, Taxpayer's marketable securities should properly be taken into account at their cost or at their net liquidation value (fair market value less cost of conversion into cash) as of the last day of the taxable year.

STATEMENT OF THE CASE

This is a tax refund suit involving the application of Sections 531-537 of the Internal Revenue Code of 1954, as amended,[1] which impose an accumulated earnings tax on corporations "formed or availed of for the purpose of avoiding income tax with respect to . . . [their] shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." The government assessed this penalty tax against Ivan Allen Company (hereinafter "Taxpayer") for its taxable years ended June 30, 1965 and June 30, 1966. Taxpayer paid the taxes with interest thereon and subsequently instituted this civil action on the grounds that the taxes and interest were erroneously and illegally assessed against and collected from it. (Appx. 5-49).

Taxpayer is an active operating company engaged in the business of selling office supplies and equipment in the metropolitan area of Atlanta, Georgia. As of the last day of each of the taxable years in question, Taxpayer held marketable securities which it purchased with a portion of its prior years' earnings and profits which it had retained for use in its business. (Appx. 55). These securities represented an investment of less than seven percent of Taxpayer's total undistributed earnings and constituted less than five percent of Taxpayer's total assets for each of the two years in question.

This litigation involves Taxpayer's relatively small investment of a portion of its earnings and profits in marketable securities of a single corporation—Xerox Corporation. As of June 30, 1965, Taxpayer had invested $116,701 of its earnings and profits in Xerox common stock and $30,625 in Xerox convertible debentures. (Appx. 55). The stock market quotations on the same day showed Xerox securities trading at a price that reflected unrealized appreciation in the "value" of Taxpayer's invested earnings and profits of $1,474,623 (market value of $1,621,949 less cost of $147,326). (Appx. 55). Similarly, at the close of its taxable year 1966, Taxpayer's $133,104 of earnings and profits invested in Xerox securities appeared to have an unrealized paper appreciation of $2,416,281 (market value of $2,549,385 less cost of $133,104). (Appx. 55).

1. Citations to statutory provisions are to sections of the Internal Revenue Code of 1954, as amended, codified in Title 26 of the United States Code.

During the years in question Taxpayer had a need for operating capital to finance the operation of its retail office supply and printing business. At the close of the taxable years 1965 and 1966, Taxpayer's need for such operating capital amounted to $1,198,309 and $1,455,222, respectively. (Appx. 56). If Taxpayer's marketable securities are taken into account at their cost, which represents the amount of Taxpayer's earnings and profits invested in such securities, Taxpayer's operating capital in the form of liquid assets was equal to the amount of such needs. (Appx. 56). If, however, Taxpayer's investments in securities are taken into account at their fair market value less the costs of conversion as of the last day of each taxable year, Taxpayer's operating capital greatly exceeded its needs for such capital. (Appx. 56).

On the basis of these undisputed facts, the parties entered into a stipulation for purposes of determining the applicability to Taxpayer of the tax avoidance presumption set forth in Section 533(a). (Appx. 53-123). Through this stipulation, the Government conceded that if Taxpayer's investments are properly taken into account at their cost—which is the extent to which they represent an investment

of Taxpayer's earnings and profits—then the earnings and profits retained by Taxpayer were retained for the reasonable needs of its business and the accumulated earnings tax was erroneously and illegally assessed against and collected from Taxpayer.[2] (Appx. 57). On the other hand, if Taxpayer is required to account for its investments of earnings and profits at their net liquidation value as of the last day of the taxable year, then Taxpayer conceded that the Section 533(a) tax avoidance presumption was applicable. (Appx. 57).

The District Court resolved this legal issue for Taxpayer, holding that neither the statute nor any Treasury Regulation required that a taxpayer finance current operations out of unrealized appreciation in the value of its assets, as opposed to its earnings and profits. (Appx. 124-127).

On appeal, the Fifth Circuit reversed the judgment entered by the District Court, holding that appreciated liquid assets must be accounted for at their net liquidation value as of the last day of the taxable year. (Appx. 131-136).

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2. It should be noted that during the years in question Taxpayer did in fact pay substantial dividends to its shareholders. The amount of such dividends was $55,510 in 1965 and $50,267 in 1966. (Appx. 56).

ARGUMENT

I.

Introduction and Summary.

The accumulated earnings tax is a penalty tax imposed in addition to the normal federal income tax paid by all corporations. This penalty tax was enacted for one purpose—to penalize and thereby deter a corporation from unreasonably accumulating its earnings and profits to avoid the income tax on its shareholders. *United States* v. *Donruss Co.*, 393 U.S. 297, 303 (1969). As a federal tax statute, and especially in view of its penal nature, the accumulated earnings tax should be strictly construed and not extended by implication so as to impose penalties on taxpayers under circumstances not specifically covered. *See Gould* v. *Gould*, 245 U.S. 151, 153 (1917).

As the District Court pointed out, neither the statute nor the relevant Treasury Regulations suggest that the unrealized appreciation in a corporation's assets should be taken into account for purposes of the accumulated earnings tax. (Appx. 126). On the contrary, the most pertinent Treasury Regulation conspicuously omits any reference whatsoever to unrealized appreciation and simply provides that in determining whether earnings and profits have been unreasonably accumulated, "the accumulated earnings and profits of prior years will be taken into consideration." Treas. Reg. § 1.535-3(b) (ii).

The Fifth Circuit's decision requires that current assets be accounted for on the basis of their fair market value less the costs of conversion as of the last day of the taxable year. This decision is legally and practically unsound for the following reasons:

(1) Section 533(a) mandates a comparison of "earnings and profits"—not appreciation in asset value—with reasonable business needs;

(2) The Fifth Circuit's decision makes the accumulated earnings tax an impediment to legitimate business decisions by forcing corporate management to resort to the unrealized appreciation of corporate assets to finance business needs, contrary not only to the well-established principle that corporate management may finance business needs solely out of earnings and profits but also to the policy underlying the "realization" concept of *Eisner* v. *Macomber*, 252 U.S. 189 (1920);

(3) The Fifth Circuit's decision assumes, contrary to reason and recent experience, that the unrealized appreciation in corporate assets on the last day of the taxable year will continue to be available for use in the corporation's business whenever needed; and

(4) By making the applicability of tax turn on complex questions of valuation, the Fifth Circuit has undermined the policy set forth in *United States* v. *Donruss Co.*, 393 U.S. 297 (1969), in which this Court placed primary emphasis on readily ascertainable objective criteria as the determining factors in the administration of the penalty tax.

On the other hand, taking assets into account at their cost for purposes of determining the applicability of the Section 533(a) presumption is consistent with both the statutory language and the purpose of the accumulated earnings tax in that:

(1) Cost reflects the full extent to which a corporation has invested earnings and profits in current assets and thereby fully serves the Congressional purpose of penalizing an unreasonable accumulation of earnings and profits;

(2) A rule of cost minimizes the degree to which the accumulated earnings tax infringes upon legitimate business decisions unrelated to tax consequences by allowing corporate management to determine the most advantageous method of financing business needs and the most advantageous time to convert corporate assets without fear of being subjected to the accumulated earnings tax; and

(3) Cost provides a readily ascertainable and measurable criterion for determining the applicability of the tax.

II.

Liquid Assets Are Significant for Purposes of Section 533(a) Only As a Measure of a Corporation's Earnings and Profits Available for Use in Its Business, and the Unrealized Appreciation in Such Assets Is Not a Part of Earnings and Profits.

Through the accumulated earnings tax Congress sought to deter shareholders from avoiding income taxes by permitting their corporations to accumulate earnings in lieu of making dividend distributions. *United States* v. *Donruss Co.*, 393 U.S. 297, 303 (1969). In recognition that a corporation can pay dividends only out of its "earnings and profits," Congress, in enacting the accumulated earnings tax, adopted the statutory measure of realized earnings—earnings and profits—as the standard by which to measure a corporation's ability to pay dividends.[3] Thus,

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3. S. Rep. No. 2156, 74th Cong., 2nd Sess. 17 (1936). This Senate Report explains the amendment to the statute by which the term "earnings and profits" was incorporated into the Section 531 penalty tax as follows: "The bill as reported substitutes for the word 'gains' the word 'earnings' wherever 'gains' is used in the section in connection with the word 'profits'. The phrase describes the fund out of which tax dividends are paid. The substitution makes no change in existing law but more accurately describes such funds and uses the same expression as is employed in Section 115 [now Section 316] and elsewhere in the act."

the accumulated earnings tax is imposed only on corporations that permit their earnings and profits to accumulate for the proscribed tax avoidance purpose. Section 532. And because a corporation with accumulated earnings and profits in excess of its business needs can in fact pay dividends without impairing its financial stability, Section 533(a) creates a presumption that the purpose of an excess accumulation of earnings and profits is tax avoidance.

By its plain and unambiguous terms, the applicability of the Section 533(a) presumption of tax avoidance is dependent upon a comparison of a corporation's accumulated earnings and profits with its reasonable business needs. Prior to the Fourth Circuit's decision in *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d 495 (4th Cir. 1960), *cert. denied*, 263 U.S. 976 (1960), most judicial decisions made this comparison by focusing almost exclusively on the amount of a corporation's total accumulated earnings and profits. *See, e.g., L. R. Teeple Co.*, 47 B.T.A. 270 (1942); *Newman Machine Co.*, 26 T.C. 1030 (1956). By emphasizing a corporation's total accumulated earnings and profits, however, while at the same time considering only a corporation's current and future business needs, these decisions failed to consider that a portion of the corporation's earnings might have been invested in such business related assets as inventory, land, buildings and machinery. Although such investments do not reduce the amount of a corporation's accumulated earnings and profits, the earnings invested in such assets have been put to use in the corporation's business and are not therefore available to meet the corporation's current and future business needs.

In recognition of this fact, virtually all Section 531 decisions since *Smoot* have focused only on the portion of a corporation's total accumulated earnings and profits available to meet its current and future business needs.

See, e.g., Electric Regulator Corp. v. *Commissioner*, 336 F.2d 339 (2nd Cir. 1964); *John P. Scripps Newspapers*, 44 T.C. 453 (1965). The courts have thus recognized that the only portion of a corporation's earnings and profits available to meet such needs are those which are held by the corporation in liquid form. *See, e.g., Electric Regulator Corp.* v. *Commissioner*, 336 F.2d at 344; *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d at 501; *John P. Scripps Newspapers*, 44 T.C. at 467. In short, a corporation's liquid assets are significant for purposes of the accumulated earnings tax solely as a measure of the corporation's earnings and profits available for use in its business. Unrealized appreciation in assets is clearly not a part of a corporation's accumulated earnings and profits. *See* Section 312(f) and Treas. Reg. § 1.312-1(b). Accordingly, such appreciation should not be taken into account in measuring a corporation's earnings and profits available for use in its business.

The Fifth Circuit, however, has concluded in the instant case that Taxpayer's marketable securities should be taken into account for purposes of making the Section 533(a) comparison at their fair market value less the costs of conversion. In so holding, the Fifth Circuit lost sight of the significance of Taxpayer's liquid assets as a measure of a corporation's realized earnings—its earnings and profits—available for use in its business. In effect, the Fifth Circuit has construed Section 533(a) as if it mandated a comparison of Taxpayer's business needs with its accumulated earnings and profits *plus the unrealized appreciation* in its current assets. Such an interpretation of the statute is not only contrary to the purpose and plain and unambiguous terms of Section 533(a) but also to the Treasury's own regulations, which quite properly make no reference whatsoever to unrealized appreciation but simply provide that in determining whether earnings and profits

have been accumulated beyond the reasonable needs of the business, "the accumulated earnings and profits of the prior years will be taken into consideration." Treas. Reg. § 1.535-3(b)(ii). *See also*, Treas. Reg. §§ 1.533-1(a)(1), 1.533-1(b), and 1.537-2.

The Fourth Circuit, when confronted with the same issue presented by the instant case, refused to consider the unrealized appreciation of a corporation's marketable securities. *American Trading and Production Corporation* v. *United States*, 362 F Supp. 801 (D. Md. 1972), *aff'd per curiam*, 474 F.2d 1341 (4th Cir. 1973). The taxpayer in *American Trading* demonstrated business needs at least equal to its earnings and profits. In addition, it held marketable securities having a fair market value far in excess of demonstrated business needs. 362 F. Supp. at 807-809. As in the instant case, the taxpayer's marketable securities had exhibited substantial unrealized appreciation in value as measured by current stock market quotations.

Notwithstanding these facts, the Fourth Circuit refused to apply the Section 533(a) tax avoidance presumption and instead adopted the District Court's reasoning that:

> [T]he purpose of the Internal Revenue Code Sections in issue, in this court's view, relate to earnings and profits and the size thereof, if any, and not to original capital and the size or growth thereof.
>
> Without earnings and profits, there can be no Section 531 tax, irrespective of the size of the original capital account, or the liquidity of the capital. 362 F.Supp. at 808.[4]

4. Although the marketable securities involved in *American Trading* were part of the taxpayer's original capital, the government has conceded in its Memorandum in Opposition to Taxpayer's Petition for Certiorari that this factor is "irrelevant." Memorandum for the United States in Opposition, p. 5.

In effect, the Fourth Circuit in *American Trading*, unlike the Fifth Circuit in the instant case, simply adhered to the Congressional purpose of penalizing only an unreasonable accumulation of earnings and profits as manifested in the plain and unambiguous terms of Sections 532 and 533 while rejecting the government's attempt to expand the scope of the penalty tax beyond its intended purpose. The essence of *American Trading* is that liquidity may be important in determining the availability of earnings and profits, but the statute penalizes only an unreasonable accumulation of earnings and profits, not liquidity.

The primary authority relied upon by the Fifth Circuit in reaching its conclusion in the instant case was this Court's decision in *Helvering* v. *National Grocery Co.*, 304 U.S. 282 (1939). During the taxable year at issue in *National Grocery*, the accumulated earnings tax penalized an unreasonable accumulation of "gains and profits". The relevant issue presented to this Court was whether the unrealized depreciation in a taxpayer's marketable securities could be deducted from its realized earnings in determining whether there had been any accumulation of "gains and profits" during the taxable year. Although the Court noted that depreciation in the market value of securities was "evidence to be considered" in determining the applicability of the accumulated earnings tax [304 U.S. at 291], it recognized that just as unrealized appreciation does not increase a corporation's accumulated earnings and profits, neither does unrealized depreciation decrease such an accumulation. 304 U.S. at 291. Accordingly, in determining the amount of the taxpayer's accumulated "gains and profits," the Court took the taxpayer's depreciated securities into account at their cost, as is dem-

onstrated by the actual figures set forth in the Court's opinion.[5]

This Court's reasoning in *National Grocery* with respect to depreciated securities is completely consistent with Taxpayer's position in the instant case. In determining the existence of an accumulation of earnings and profits, the Court concluded that depreciation in marketable securities could not be taken into account. Similarly, it is Taxpayer's position that the unrealized appreciation in marketable securities should not be taken into account in determining the amount of a corporation's accumulated earnings and profits.

Moreover, in determining the availability of a corporation's accumulated earnings for use in its business, Taxpayer recognizes, in accordance with *National Grocery*, that both the appreciation and depreciation of any marketable securities held by the corporation is "evidence to be considered." If the marketable securities have depreciated in value, there is strong evidence that the corporation's earnings and profits invested in such securities are not fully available to meet the corporation's business needs. Since they are not fully available, the full amount of the earnings and profits invested in such assets should not be taken into account in determining the applicability of the Section 533(a) tax avoidance presumption.

On the other hand, if the marketable securities have increased in value, there is substantial evidence that the full amount of the corporation's accumulated earnings and profits invested in such securities are in fact available to meet the corporation's business needs. In such a case,

5. 304 U.S. at 291. The figures set forth in this Court's opinion represented the cost of the securities rather than their diminished market value, as is shown by the opinion of the Court of Appeals, 92 F.2d 931, 935 (3rd Cir. 1937).

the full amount of a corporation's accumulated earnings and profits which have been invested in such securities—an amount equal to their cost—should be taken into account in determining the applicability of the accumulated earnings tax. For this reason, Taxpayer has agreed that the full amount of its realized earnings invested in its liquid assets—their cost—should be taken into account in determining the applicability of Section 533(a).

In sum, Taxpayer is advocating that the same measure be applied to appreciated securities as this Court applied to depreciated securities in *National Grocery*. This measure is the amount of earnings and profits which have been invested in such securities and which are available to meet Taxpayer's business needs—the measure required by the clear and unambiguous terms of Section 533(a).

III.

Congress Adopted Earnings and Profits As the Sole Standard by Which to Measure a Corporation's Ability to Meet Its Business Needs and to Pay Dividends, Without Regard to the Unrealized Appreciation in Its Assets or Other Available Sources of Funds.

By adopting the standard of earnings and profits as the sole measure of a corporation's ability to meet its business needs and to pay dividends, Congress adhered to the fundamental tax principle first enunciated by this Court in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), which requires the "realization" of a taxpayer's gains and profits before subjecting him to taxation.[6] In so doing, Congress successfully avoided injecting the problems of an annual valuation and a forced conversion of a corporation's assets

6. In 1921 Congress revised the structure of the accumulated earnings tax into its present form in light of this Court's decision in *Eisner* v. *Macomber*. Revenue Act of 1921, § 220, 42 Stat. 247 (1921).

into the accumulated earnings tax—two problems which led this Court in *Eisner* v. *Macomber* to adopt the "realization" concept. 252 U.S. at 213, 215. The Fifth Circuit, however, by its decision in the instant case, has now injected these very problems into the administration of the accumulated earnings tax.

A. Corporate Management, in the Exercise of Sound Business Judgment, May Elect to Finance Business Needs Solely Out of Accumulated Earnings and Profits Without Resorting to the Unrealized Appreciation in Corporate Assets.

A significant factor and perhaps the underlying premise of the Fifth Circuit's conclusion in the instant case was that the unrealized appreciation in Taxpayer's marketable securities was readily available for use in its business. (Appx. 134-135). The effect of this reasoning is to force Taxpayer and all other corporations similarly situated to convert their appreciated assets in order to meet their business needs, thus defeating one of the purposes underlying the realization principle of *Eisner* v. *Macomber*.[7] Such reasoning, however, not only makes the accumulated earnings tax an impediment to legitimate business decisions but also departs from the well-established principle that corporate management may legitimately elect to finance corporate business needs solely out of earnings and profits without regard to other available sources of funds and

7. 252 U.S. 189. Although the Fifth Circuit indicated that it was not attempting to dictate the point in time at which appreciated assets are to be sold and that its decision "does not force the corporation to liquidate these securities," the Court recognized that Taxpayer, "as a consequence of its own sound business judgment in making profitable investments, must sell, exchange or distribute to the shareholders assets in order to avoid an excessive accumulation of earnings. . . (Appx. 136)." Indeed, the entire thrust of the Fifth Circuit's decision is that taxpayer must resort to the unrealized appreciation in its marketable securities to finance its business needs so that its earnings can be distributed to its shareholders.

without fear of being subjected to the accumulated earnings tax. For these reasons, the courts have uniformly rejected the government's attempts to impose the accumulated earnings tax on corporations whose management has refused to resort to borrowing but has instead elected to finance its business needs solely out of earnings and profits.[8]

Similarly, corporate management should be entitled, in the exercise of its business judgment, to finance business needs solely out of earnings and profits without resorting to unrealized appreciation through a forced liquidation of corporate assets and without fear of being subjected to the accumulated earnings tax. This is particularly true when one considers that in a forced liquidation of its securities to secure the funds necessary to meet its business needs, Taxpayer would not only have been deprived of deciding upon the most advantageous time to dispose of its securities but would also have suffered a loss of at least 37% of their value.[9]

8. *See, e.g., Duke Laboratories, Inc.* v. *United States*, 337 F.2d 280 (2nd Cir. 1964); *Electric Regulator Corp.* v. *Commissioner*, 336 F.2d 339 (2nd Cir. 1964); *R. Gsell & Co., Inc.* v. *Commissioner*, 294 F.2d 321 (2nd Cir. 1961); *John P. Scripps Newspapers*, 44 T.C. 453 (1965); *Carolina Rubber Hose Co.*, 24 CCH Tax Ct. Mem. 1159 (1965); *Gazette Telegraph Co.* v. *Commissioner*, 19 T.C. 692 (1953), *aff'd*, 209 F.2d 926 (10th Cir. 1954); *A. H. Phillips, Inc.*, 10 CCH Tax Ct. Mem. 1007, 1013 (1951); *Kennedy Nameplate Co.*, 6 CCH Tax Ct. Mem. 622, 633 (1947), *aff'd*, 170 F.2d 196 (9th Cir. 1948); *General Smelting Co.*, 4 T.C. 313 (1944).

9. The government recognizes the loss in value which would have resulted from federal income taxes (25%) and brokerage commissions (6%). The 5% income tax which would have been imposed by the State of Georgia, however, has not been taken into account. *See* GA. CODE ANN. § 92-3102. For taxable years beginning after 1969, the loss in value would be almost 50% as a result of the federal capital gain tax rate being increased to 30% and the inclusion of capital gains as a "tax preference item" subject to an additional 10% tax. *See* Int. Rev. Code § 1201, § 56 and §57. Moreover, this loss in value will vary depending upon the rate of the capital gains tax imposed by the different states.

In short, the Fifth Circuit's reasoning leads inevitably to the conclusion that a corporation, in order to avoid the accumulated earnings tax, must avail itself of the unrealized appreciation in its assets to finance its business needs without regard to the business judgment of corporate management and without regard to the severe loss which would be suffered in disposing of such assets. Nothing in the accumulated earnings tax provisions, however, or in the relevant Treasury Regulations, requires a corporation either to liquidate its investments or to face the imposition of an accumulated earnings tax.

B. The Fifth Circuit's Decision Assumes That the Unrealized Appreciation in Corporate Assets As of the Last Day of a Taxable Year Will Continue to Be Available for Use in the Corporation's Business Whenever Needed.

Not only does the Fifth Circuit's decision require corporate management to resort to unrealized appreciation in corporate assets to finance business needs, but it also assumes that the unrealized appreciation in such assets on the last day of a taxable year will continue to be available for use in the corporation's business whenever needed. The economic downturn that has occurred since the Fifth Circuit's judgment was entered in May of 1974, dramatically illustrates that this assumption is unwarranted. During the three-month period from June 28, 1974 to September 30, 1974, the Dow-Jones Industrial Average of all common stocks declined by approximately 24% while the value of Xerox common stock declined by approximately 44%. If during this three-month period corporations had relied solely on the unrealized appreciation in their common stock investments to meet their business needs, these needs would not have been satisfied.

In short, the Fifth Circuit's use of the market value of corporate assets as a standard by which to measure a corporation's ability to meet its future business needs is inconsistent with sound business judgment. Indeed, all of the District Courts which have been confronted with this issue have recognized this problem and have reached the conclusion that such a position is impractical as well as legally unsound.[10] As pointed out by the District Court in the instant case:

> The value of a particular stock would depend upon a wide array of imponderables relating principally to the condition of the company whose stock was held, and the myriad of factors that affect the stock market itself—such as whether Henry Kissinger should go to Paris on December 30th—all far beyond the control of the company holding the investment. Adoption of the government's position would require business men to employ persons specializing in crystal ball gazing rather than sound business management. (Appx. 127).

C. Adherence to Earnings and Profits As the Sole Standard by Which to Measure a Corporation's Ability to Meet Its Business Needs and to Pay Dividends Avoids the Administrative Problems of an Annual Valuation of Corporate Assets.

The effect of the Fifth Circuit's decision in the instant case is to make the applicability of the accumulated earnings tax dependent upon the value of corporate assets as of the last day of a taxable year, thus creating the

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10. *See, e.g.*, District Court Opinion below (Appx. 124-127); *American Trading & Production Corp.* v. *United States*, 362 F. Supp. 801 (D. Md. 1972), *aff'd per curiam*, 474 F.2d 1341 (4th Cir. 1973); *Harry A. Koch Co.* v. *Vinal*, 228 F. Supp. 782 (D. Neb. 1964).

administrative problems and uncertainties among corporate managements inherent in an annual valuation of assets which Congress had apparently avoided in structuring the tax around a corporation's "earnings and profits." Indeed, it is for this very reason that the unrealized appreciation in a corporation's assets does not affect its earnings and profits. *See* BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 7-13 (3rd Ed. 1971). By virtue of the Fifth Circuit's decision, however, if a corporation's assets consist of stock of closely held corporations, interests in partnerships, or real estate for which there is not a ready market, the applicability of the Section 533(a) presumption and thus the corporation's liability for the accumulated earnings tax will turn on complex questions of valuation which will be thrust upon the judiciary to answer on the basis of the myriad opinions men may have with respect to the value of corporate assets. Introducing this element into the accumulated earnings tax is contrary both to the policy underlying the "realization" concept of *Eisner* v. *Macomber*, 252 U.S. 189 (1920), and to the policy expressed in *United States* v. *Donruss Co.*, 393 U.S. 297 (1969), which, consistent with the fact that the accumulated earnings tax is a penalty tax, placed primary emphasis on readily ascertainable objective criteria as the determining factors in the administration of the tax.

CONCLUSION

For the reasons stated above, Taxpayer respectfully submits that the judgment of the Court below should be reversed.

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